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TAGS: ECON PGOV HR ECONOMIC CONDITIONS
SUBJECT: CROATIAN ECONOMY - THE DIFFERENCE A YEAR MAKES

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¶1. Summary: Croatia's economy grew strongly in 2007, with most analysts predicting an annual growth rate of 5.9 percent. Fueled largely by increased consumption, government revenues also grew at a better-than-expected rate, rising nearly 15 percent. The government's fiscal deficit is expected to be less than 3 percent of GDP. However, with the global economic environment changing, 2008 promises to be much less benign for Croatia. Higher inflation and flat consumption are likely to result in slower growth and pressure for wage increases. Government revenue growth will also slow at a time when a new government has come to power with promises of spending increases to coalition partners that could prove difficult to reconcile with its platform of fiscal consolidation. End Summary.

Economy Solid in 2007

¶2. By most accounts, 2007 was a good year for Croatia's economy. Analysts' estimates predict an annual growth rate of 5.9 percent. Inflation, although rising at the end of the year, was 2.9 percent overall. Meanwhile, strong revenue growth of nearly 15 percent enabled the government to continue with its program of fiscal consolidation with projections that the fiscal deficit will drop to 2.8 percent. At the same time, central bank policies to limit foreign currency credit growth appear to have taken hold, leading banks to increase their share of kuna lending, effectively stabilizing Croatia's substantial foreign debt at 86 percent of GDP.

Consumption-led Growth

¶3. Growth, which was above Croatia's six-year average of 4.78 percent, was driven largely by increased consumption, which accounts for around 60 percent of Croatia's GDP. Bank lending, which has been a strong driver of Croatia's economy, increased at a slower pace than in previous years, but still grew by 16 percent from 2006. At the same time, four large lump sum payments to nearly half a million pensioners injected nearly 5.7 billion kunas (USD 1.1 billion) into the economy from mid-2006 until November 2007. These payments were part of a settlement of a "debt" to pensioners that has largely been cleared with the last payment in November. The government financed these payments through sales of its shares in the pharmaceutical company Pliva to Barr Pharmaceuticals of the U.S. and through IPOs of shares in the national oil company INA and the national telecom firm HT.

Economic Environment Not So Benign in 2008

¶4. Croatia has begun to feel some of the consequences of volatility in international markets and rising energy prices. Inflation reached 4.5 percent in December, prompting calls for government action (reftel). Central Bank Governor Zeljko Rohatinski has said on several occasions that inflation could be as high as 6 percent in
¶2008. Consumption, which accounts for 60 percent of Croatia's GDP, is also expected to slow as consumers feel the pinch of higher

prices. The tightening of credit markets has already been felt in Croatia as interest rates have begun to rise. Consequently, analysts expect 2008 GDP growth to be a least a percent lower.

No Second Mandate Honeymoon for Sanader

¶5. The Croatian economy has strong seasonal variations due to the heavy influence of summer tourism, which accounts for one fifth of GDP. As a result, GDP growth rates are calculated against the same quarter of the previous year. Last year saw an unusually high growth rate of 7 percent in the first quarter, coupled with an inflation rate of only 1.6 percent. Price hikes across the economy since the first of the year, coupled with a slowdown in consumer spending are likely to provide a very unfavorable comparison with last year when first quarter results are tabulated this spring.

¶6. The coalition government of PM Ivo Sanader is likely to face many more difficulties on the economic front in 2008 than during his previous four year tenure. Adding to this are the demands of his coalition partners for large spending increases in agricultural subsidies, the abolishment of health insurance co-payments and other commitments that could be difficult to reconcile with the government's promise of continued fiscal consolidation. With a slowing economy, rising prices and lower government receipts, Sanader will have a more difficult time keeping economic policy on track, his coalition partners on board and the opposition at bay.

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